BLOCKCHAIN TECHNOLOGY LAW ALERT

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A Warning to Investors: SEC Signals Enforcement Action against Coinbase Exchange

On March 22, 2023, the Securities and Exchange Commission ("SEC") issued crypto exchange platform, Coinbase Global, Inc. ("Coinbase"), a Wells notice, warning the exchange that it identified potential violations of United States securities laws.

A Wells notice is a formal notice from the SEC informing the recipient that the SEC is planning to bring civil enforcement actions against it and gives the recipient the chance to offer information as to why such action should not be brought. The notice is typically one of the final steps before the SEC formally issues charges. However, a Wells notice does not always result in charges or signal that the recipient has violated any law.

According to a press release by Coinbase, the Wells notice raises questions concerning an "unspecified portion of [its] listed digital assets" as well as Coinbase's staking service—Coinbase Earn. The process of staking allows cryptocurrency owners to earn passive income in exchange for supporting the blockchain. In sum, transactions on the blockchain must be validated, and those who do the validating earn rewards (*i.e.,* more cryptocurrency). Validators must also, in essence, post a specified amount of cryptocurrency as security—if the validator improperly validates fraudulent data, their "stake" is "slashed" as a penalty. Users who stake their cryptocurrency with services like Coinbase Earn typically earn yields that are greater than those offered by traditional banks for savings accounts.

Coinbase maintains that it has cooperated with the SEC by turning over documents and providing witness testimony about its exchange and staking platforms and, in light of that, that the issuance of a Wells notice is "unusual." Whether an enforcement action will actually be pursued by the SEC remains to be seen.

Recent SEC Enforcement Actions and Bankruptcies

The Wells notice issued to Coinbase comes on the heels of a tumultuous year for the crypto industry and months of back and forth with the SEC as the federal government inches closer to regulating the volatile and largely unregulated-by-design industry.

The notice to Coinbase is the second warning from the SEC to a cryptocurrency entity after a February notice to stablecoin issuer Paxos Trust Company. The SEC also recently charged the founder of BitTorrent for the alleged sale of unregistered securities, fraud and market manipulation, and charged actress Lindsay Lohan for participating in the paid promotion of digital assets without disclosing her compensation.

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Additionally, the SEC has taken action against cryptocurrency exchanges, including Kraken, which as of early February, agreed to pay a $30,000,000.00 million fine and end its “staking-as-a-service” offering. That service appears to be similar to Coinbase Earn, which is the subject of the Wells notice issued to it.

All of this follows last year’s chapter 11 bankruptcy filings by Celsius Network, a cryptocurrency lender that also provided staking opportunities to its users, and FTX, a cryptocurrency exchange. In the Celsius bankruptcy, U.S. Bankruptcy Judge Martin Glenn ruled that users who deposited their cryptocurrency in the Celsius Earn program had transferred title to their assets to the company, thus making those assets part of the bankruptcy estate. Those users have been without access to their cryptocurrency for over nine months and are now unsecured creditors hoping for a fraction of their assets back.

Consumer Protections

Cryptocurrency is known for being a risky investment, and the digital assets that you keep on an exchange or in a hot or cold wallet are not insured as they might be if deposited with a bank. Coinbase’s website states that, “Coinbase is not a Federal Deposit Insurance Corporation (“FDIC”) insured bank and cryptocurrency is not insured or guaranteed by or subject to the protections of the FDIC or Securities Investor Protection Corporation, and may lose value. In case of a covered security event, we will endeavor to make you whole.” In light of the recent decision in the Celsius bankruptcy, and the SEC’s heightened interest in providers of staking services, consumers should accord Coinbase’s promise to make account owners “whole” little weight.

If you own cryptocurrency, you should be aware of the turbulent state of the industry. Review the terms of service that apply to any exchange, account or wallet where your assets are stored. If you are staking your cryptocurrency, be aware that your assets could be at risk in the case of a bankruptcy case. If you are of the “HODL” mindset—*i.e.,* long term ownership or “hold on for dear life”— consider holding your assets off-chain in a cold hardware wallet provided that you can engage in best practices for the wallet’s security.

Ruskin Moscou Faltischek P.C. recently launched a Blockchain Technology and Digital Asset Practice Group chaired by Jessica M. Baquet, with the requisite experience, skill and capability to address these and additional complex issues that concern blockchain technology and digital asset ownership. The Group's members include RMF attorneys Michael L. Faltischek, Steven J. Kuperschmid, Alexander G. Bateman, Michael S. Amato, Stephen E. Fox, Richard M. Frankel, David R. Schoenhaar, Daniel E. Shapiro, Andrew T. Garbarino, Alexandra C. Piscitello, Samantha M. Guido and Nicole E. Osborne.

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